CAPITALIZATION OF RAILROAD SURPLUS[1]

After many years of hesitation, our National Legislature incorporated in the Transportation Act of 1920[2] the necessary clauses to centralize control over security issues of the railroads in the hands of the Interstate Commerce Commission, giving them sole control of all capital issues of the railways of the United States.

It is no longer possible for a carrier to issue any sort of stock, bonds, or other evidences of indebtedness, with the single exception of a small amount of short-time notes, unless it has first applied for permission to the Interstate Commerce Commission and received its authorization. This will only be given after a full investigation of all the facts, and a considerable degree of liberty of action is allowed the Commission in that it may either grant or deny an application, in whole or in part, or with such modifications as it deems desirable.

The two years which have elapsed since the Act became effective have been characterized by unusually abrupt changes in the business cycle. It was launched just prior to the promised date for returning the roads to their private owners, being signed by the President on February 28, 1920; and the two or three months which followed witnessed the final upswinging of the price level which preceded the crash of prices and the consequent depression from which we have not yet recovered.

The Interstate Commerce Commission was thus forced into the situation at a time when interest rates were higher than they ever had been in recent history, when the investing public was at least cool toward the poor-paying securities of the railroads, and when the problem of future needs was badly clouded by the postboom traffic situation. The succeeding months of this

[1] A paper presented before the Economics Section of the Michigan Academy of Sciences, meeting at the University of Michigan, Ann Arbor, March 30, 1922.

[2] Public Act No. 152, Sixty-sixth Congress, known as the Transportation Act, 1920.

period have been abnormal, and in many cases critical in the financial affairs of the carriers.

The Commission in accepting the new responsibility placed upon it by Congress has indicated that it will not attempt to develop new and startling theories of its own. Instead of trying to blaze a new trail, it has "chosen the part of statesmanship" and has laid out for itself a plan that should stand the stress and strain of any sort of financial situation, building on the best practice in state regulation of the past—setting a sure foundation for the future.

Provisions of the Act governing security regulation.—The provisions of Section 20*a* of the Transportation Act of 1920,[1] under which the Commission acquires its authority over security issues, are too well known to need detailed statement here. It is unlawful for any carrier to issue stocks, bonds, or other evidences of indebtedness unless approved by the Commission. The issue must be for a lawful object within the corporate purpose of the road, and it must be compatible with the public interest. The purpose must also be necessary, appropriate for, and consistent with the proper performance by the road of service to the public, as a common carrier, and one which will not impair its ability to perform that service.

Considerable discretionary power resides with the Commission in that it may either grant or deny an application, in whole or in part, or with such modifications as it deems desirable.

The carriers must make special or periodical reports as required by the Commission, showing what disposition has been made of the securities and how the proceeds have been applied.

The government does not guarantee any issues which have been authorized under the Act.

The regulatory powers of the Commission do not extend to short-time notes, if the total does not exceed 5 per cent of all issues outstanding by the carrier. Only information regarding such issues is required to be filed.

[1] Transportation Act, 1920, Section 439, amending the Interstate Commerce Act by inserting a new section, to be designated Section 20*a*.

Obligations issued without authorization are void; but the rights of bona fide purchasers of such unauthorized securities are protected and officers and agents responsible for their issuance are held liable and may be punished by fine or imprisonment.

The jurisdiction of the Commission is exclusive and plenary, and its approval, without further authority, is sufficient to give final validity to the issuance of securities and the assumption of obligations by the carriers.[1]

Surplus earnings as a basis for capitalization.—The most important cases which have so far come up for decision by the Interstate Commerce Commission deal with the issuance of securities against the accumulated surplus earnings of the roads. This opens up the whole subject of property rights in these earnings—as to whether they belong outright to the roads, on the basis of having been earned by efficient operation under regulated rates, which are assumed to be not excessive; or, on the other hand, to the public, which has supported the roads with its patronage and so is the ultimate source of such surplus; or perhaps on a middle ground, to the carrier in trust for the public, with the implication that use for any strictly private purpose is antagonistic to the public interest. This last interpretation would be of particular force if the surplus were capitalized and then used as an argument to support an increase in rates, based on such increase in capitalization.

Of these recent surplus cases, the Burlington and Lackawanna applications are of primary importance.

THE BURLINGTON CASE[2]

In 1901 the Great Northern and Northern Pacific railroads jointly acquired control of the Chicago, Burlington, and Qunicy Railroad system by the purchase of $108,000,000 par value, or 96.79 per cent, of its capital stock. The price set was $200 a

[1] For a complete treatment of the origin and provisions of the Transportation Act, see I. L. Sharfman, *The American Railroad Problem*, chap. xi. Provisions regarding security issues, pp. 419–22.

[2] *Finance Docket 1069, I. C. C.* References are to sheets of the advance copies of the decision. The Commission advises that the decision will be permanently reported in Vol. LXVII, *I. C. C.*, p. 156.

share[1] and payment was made in joint collateral 4 per cent bonds maturing July 1, 1921. The stock acquired was pledged as collateral security on the bonds. The principal amount of the joint bond issue of the northern roads for this purchase was $215,227,000.

On January 4, 1921, the Burlington applied to the Interstate Commerce Commission for permission to use part of its book surplus as a basis for new security issues in order to facilitate the refunding of these maturing obligations by the controlling roads—the virtual owners of the Burlington. Specifically, the Burlington desired to issue $60,000,000 par value of capital stock and $109,000,000 of first and refunding mortgage bonds.

Reasons for the proposal of this plan.—The Burlington's former financial plan was cumbersome, and burdened with several closed mortgages. A general mortgage maturing in 1958 covers substantially all of the property which was in existence in 1908. This is a first lien on more that 5,000 miles of the road. Bonds can be issued under this mortgage, but they are limited to $300,000,000 outstanding at any one time. They may not bear more than 5 per cent interest, nor can they be made redeemable before 1958.

At the time of this application, bonds to the amount of $65,247,000 were outstanding under this mortgage. Prior-lien bonds issued under other mortgages, known as the Nebraska extension and Illinois Division mortgages, will mature in 1927 and 1949, respectively. Provision might be made for refunding these issues, when they mature, under the general mortgage. This would require approximately $105,024,000, and would leave a possible total of $129,729,000 for other purposes before the limit would be reached and the mortgage closed.

The Burlington pointed out that it would not be feasible to issue bonds under this old mortgage at the present time. Such bonds, if they could be sold at all, could only be sold at a heavy discount, as the current interest rate was materially higher than the 5 per cent they could bear. Selling at a large discount would

[1] W. Z. Ripley, *Railway Problems* (rev. ed. 1913), p. 558. Reprinted from "A History of the Northern Securities Case" by B. H. Meyer, *Bulletin of the University of Wisconsin, No. 142*, July, 1906, pp. 225–41.

result in a large fixed charge for a long term, and would be in a high degree undesirable, since it would probably extend over several periods in which lower interest rates may prevail.

Also, if the current rate of growth of the road continues, the amount that might be realized from the sale of such bonds would not meet the road's needs for additions and betterments beyond 1933, and if the proposed dividend were paid, not beyond 1929. This would make it necessary later to revise the entire financial plan of the company. It was therefore proposed to close the general mortgage without issuing further bonds under it, and to make a new mortgage of a more modern type. The Nebraska extension and Illinois division mortgages were already closed.

The new plan of the Burlington.—The road asked authority to issue $60,000,000 additional capital stock, thus capitalizing part of its book surplus. This stock would then be used as a necessary basis for a new mortgage. The mortgage proposed was to be a fifty-year first, and refunding mortgage, "to secure coupon bonds to be issued in series at interest rates, and redeemable at times, and on terms, to be determined by the directors at the date of issuance, subject to (the Interstate Commerce Commission's) approval."[1] The mortgage would limit the amount of such bonds to three times the outstanding capital stock.

Immediately, the road desired to issue $109,000,000, principal amount, of bonds against this mortgage. The proposed financing would give a ratio of bonds to stock of about 1.5 to 1.

It is important to note that, if the bonds were issued, they would increase the Burlington's fixed charges by something like $4,800,000, or 65 per cent.

Of the proposed new issue of bonds, $29,000,000 were to be held for making future additions and betterments, and the remaining $80,000,000, together with the $60,000,000 of stock, were to be issued as a dividend. Practically all of this would go to the Great Northern and Northern Pacific as majority owners. These roads planned to use their part of the bonds to

[1] *Finance Docket No. 1069, I.C.C.*, sheet 4.

retire something over one-third of the $215,227,000 of joint 4 per cent, purchase-money bonds, which were coming due in July.

The use of these bonds to help meet that obligation was expected to materially reduce the fixed charges of the northern roads in the refunding operation, since these Burlington securities could be issued at a 6 per cent interest rate, while it was believed that a new issue of the northern roads would have to bear 8 per cent. This difference was due to the more favorable credit position of the Burlington. In practice, the rate for the northern roads was found to be 6½ per cent when they issued bonds for this purpose. See *Finance Docket No. 1374, I.C.C.*

Outstanding securities of the Burlington.—At the time of this application, to the Interstate Commerce Commission, the Burlington had outstanding $110,839,100 par value of capital stock and $174,040,800 of bonds, most of which was in the hands of the public. All such securities amounted to only $31,164 per mile of road, a remarkably low capitalization for a prosperous American road, when it is considered that in 1912 the capitalization of railroads in the United States averaged $63,535 per mile of line.[1]

Desirability of control of the Burlington.—The northern roads had acquired control of the Burlington in order to obtain an outlet to Chicago and the Middle West.

In relation to the Great Northern and Northern Pacific, the Burlington is like the point and moldboard of a plow, the beam and handles of which are constituted by the former systems. The Burlington connects Chicago with St. Louis, Kansas City, Omaha, Denver, St. Paul, and Minneapolis, and numerous smaller but important cities, which, taken collectively, represent the manufacture and sale of every staple commodity and the raw materials therefor.

An alliance with a system possessing the tactical and physical advantages of the Burlington could not be otherwise than a source of strength and profit to the party making such an alliance.[2]

. . . . The Great Northern and Northern Pacific companies each purchased an equal number of shares of the Burlington stock as the best

[1] Johnson and Van Metre, *Principles of Railroad Transportation*, p. 111.

[2] W. Z. Ripley, *Railway Problems* (rev. ed. 1913), pp. 556, 557. (Quoting Meyer.)

means and for the sole purpose of reaching the best markets for the products of the territory along the lines, and of securing connections which would furnish the largest amount of traffic for their respective roads, increase the trade and interchange of commodities between the regions traversed by the Burlington lines and their connections and the regions traversed or reached by the Great Northern and Northern Pacific lines, and by their connecting lines of shipping on the Pacific Ocean, and as the best if not the only means of furnishing an indispensable supply of fuel for their own use and for the inhabitants of the country traversed by their lines. These connections and the interchange of traffic thereby secured were deemed to be and are indispensable to the maintenance of their business, local as well as interstate, and to the development of the country served by their respective lines, and of like advantage to the Burlington lines and the country served by them, and strengthen each company in its competition with European carriers for the trade and commerce of the Orient.[1]

Earnings and property values.—For twenty years the jointly owned Burlington has been one of the most successful railway properties in the country.

Instead of using the large earnings of this period for dividend purposes, which would have been paid principally to the Great Northern and Northern Pacific, the Burlington followed a policy of reinvestment to perfect the physical equipment of the road. Since July 1, 1901, it has invested over $189,000,000 out of earnings in additions and betterments to its property, and has also retired old bonds to the amount of $191,348,478.39. No part of this reinvestment or retiring of bonds with earnings has been capitalized.

The Burlington's average dividend rate for twenty years from 1901–20 was only 8.51 per cent on the abnormally low capitalization, and less than 4 per cent on the average property investment in excess of all outstanding bonds. This policy built up the road and equipment to a book investment value of $503,745,837.57. Since the outstanding securities already mentioned amounted to $284,879,900, a book surplus has accumulated amounting to $218,865,937. It is a part of this surplus which the road now desired to capitalize. In addition to the book surplus, the road also claimed there were some $70,000,000

[1] George B. Young, *Brief for the Defendants. U.S. of A.* vs. *Northern Securities Company, et al. C.C. of U.S.*, p. 21. (Quoted by Meyer.)

of investment in property other than road and equipment, not shown in the surplus account.

Illinois Commission's previous decision.—Previous to the present application, the Illinois Public Utilities Commission had granted an application for the right to capitalize a portion of the Burlington's surplus, and this approval was urged by the road in seeking the Interstate Commerce Commission's sanction of the present issue. While the Commission was willing to consider such a precedent, it felt that confusion had been injected into the case, because the authorization by the Illinois Commission was for the purpose of reimbursing the treasury for expenditures in additions and betterments to the road, while the present plan was intended for dividend purposes and the source of the securities would still be the company's surplus. The question also failed to be analogous in the opinion of the Commission, in that the earlier grant was made in a normal period, while this was asked for in an abnormal period, at an abnormal rate of interest, and the Commission considered that the "only material advantage anticipated would inure to parties other than the applicant."[1]

Issues in the Burlington case.—The issue before the Commission was: (1) Whether or not an actual surplus existed, (2) whether it had come into existence legitimately, (3) the relation of present capitalization to actual investment or fair value, (4) whether or not the present financial structure was adequate for future needs, and (5)—and most important—whether or not the Burlington could declare dividends from invested surplus acquired from earnings during a period when regular dividends had been paid.

While the ultimate decision as to valuation, and hence the ultimate basis of financial regulation, still remains with the courts, and will be with them until the present physical valuation now in process by the Commission is completed, this by no means precludes the examination of matters of valuation by the Commission as they are presented to it in connection with an application.

[1] *Finance Docket No. 1069, I.C.C.*, sheet 6.

In the present case, the Commission was at some pains to compare the physical value claimed by the road with the capital outstanding, and to trace the flow of net income for the last ten-year period. Its purpose was to find an adequate basis for determining the actual surplus, from which the new issue was expected to be made.

The state of Nebraska was the only objector to the application, and it did not deny the existence of the property values claimed, and the Commission was inclined to accept the same view, with the qualification that "allowance should be made, however, pending the valuation of the applicant's system, for shrinkage of book values, so that the adjusted capitalization will not leave the applicant with an inadequate actual surplus."[1]

The Burlington decision.—The decision[2] of the Commission dealt with each of the main points at issue, and among other things acknowledged: (1) the existence of a "great uncapitalized surplus," which had been accumulated under regulated rates. It also found that there was no proof that the rates had been excessive. (2) That the existing capitalization was far below the actual investment or any fair value for rate-making purposes which the Commission may subsequently fix under the Valuation Act. (3) That the increase in capitalization following a grant of authority would still leave the total below the actual investment and probable fair value of the property devoted to public service. (4) That a sufficient surplus for corporate purposes would still remain if part of the surplus were capitalized. And (5) that the old financial structure was obsolete and inadequate, and that new form of mortgage and a larger stock base to meet the requirements of statutes governing investments by savings institutions in various states was necessary.

On this basis the proposed stock dividend was authorized, but the bond issue was denied. This denial rested on the

[1] *Ibid.*

[2] The following commissioners participated in the decision of the Burlington case of February 28, 1921 (*Finance Docket No. 1069, I.C.C.*): Clark, *chairman*, McChord, Meyer, Hall, Daniels, Aitchison, Eastman, Potter, and Ford. The majority authorized the $60,000,000 stock dividend, but denied the bond issue. Commissioners Clark, Daniels, Potter, and Ford believed the bonds should have been authorized. Commissioner Eastman would have denied both issues.

debatable ground that the increase in fixed charges which would result was an unnecessary burden to the road. The Commission believed that such increases should be borne by the northern roads, since they would be primarily incurred to allow the Great Northern and Northern Pacific to retain control of the Burlington.

The majority of the Commission was convinced that the refunding could be accomplished by the northern roads alone at a reasonable rate by the issuance of bonds secured both by mortgage on those roads and by the pledge of the Burlington stock, as in the original purchase, and they incorporated this opinion in the decision.

Commissioners Clark, Potter, and Ford did not share the majority opinion, and their judgment was found to be sound, for the second plan which was formulated and presented by the northern lines on April 11, 1921, carried an even higher interest rate than the first application of the Burlington. These commissioners wished to have the Burlington bonds approved, believing such an order would better serve the public interest.

Important minority opinions in the Burlington case.—Commissioner Daniels in dissenting from both findings of the majority, held that the permission granted would largely be ineffectual, because the benefits of the stock issue authorized would be remote, while that of a bond issue would have been immediate. Since the Burlington is jointly owned by the northern roads, he thought it an essential error to treat this road as a separate entity. The Burlington is practically the strongest member of the group, and therefore since the plan proposed would make it a joint obligor with the others in refinancing the maturing obligations, the resulting issue would have an unusually favorable position in the market. This reasoning is undoubtedly sound, as was his conclusion that high rates of interest are a result of universal dearth of capital seeking investment, as compared with the current demand therefor. An opinion was expressed by counsel during the hearings that such high rates were due to the action of groups of bankers.

In a long and detailed opinion opposed to any phase of the capitalization of surplus, Commissioner Eastman held that the

saving in interest (which he considered the principal argument in favor of the Burlington plan) was not based on sound reasoning; and he attempted to examine the matter from the standpoint of the original stockholders. He believed that these stockholders would not insist on a doubling of their return at a time when the railroads were struggling against a temporary tide of depression. He also called attention to the fact that the real question is one of a distribution from surplus, and that no *right* of such issue rests with the roads. It is a *privilege*, subject to the authority of the Commission. The majority later adopted this view and incorporated it in the Lackawanna decision. Commissioner Eastman also pointed out that a sound policy would accumulate surplus coincident with payment of dividends in any railroad enterprise.

Commissioner Eastman also took the stand that no absolute right of ownership of surplus rests in the hands of the roads. He said that: (1) The property is dedicated to a public use and (2) the public might have prohibited the acquisition of a surplus except for purposes of improvement by the simple expedient of not allowing rates high enough for one to accumulate. Also, he holds, the matter of "fair value" is yet indefinite. Value, as used by the courts, is different from customary usage. It is an open question whether property acquired from excess earnings is to be treated differently from other property in valuation for rate-making purposes. A trust in connection with the surplus rests with the Commission, and while the applicant may have a right to returns based on the surplus, the body of value itself cannot be turned into stocks and bonds without the commissioners' approval.

Commissioner Eastman also quotes and criticizes certain other minor reasons offered in support of the issue of the proposed stocks and bonds, which are worthy of careful consideration:

1. The claim that a more modern and flexible mortgage can be secured, based on this issue of stock, and so an adequate provision made for the bond issue. Commissioner Eastman holds it is necessary to distinguish between the real and the *apparent* foundation in such cases. No real values are created

by such processes. Inflation of the capital base adds no new property to the road.

2. The claim that it will encourage investment in railroad securities. This can best be secured by conservative management, and will not be aided by manipulation of securities.

3. The claim that denial would cause stockholders to want all future surplus distributed. This is not based on fact, he believes, as a railroad's credit position is enhanced by the accumulation of surplus, rather than impaired.

Before this case came before the Commission, Professor Bonbright[1] had pointed out the weakness of this same argument. It assumes that the past high earnings could have been paid as dividends in cash. While this may legally be true, it is practically doubtful, according to Professor Bonbright, for roads would not have dared to distribute cash to such an extent as to impair their property, because of the danger of incurring public ill will.

4. The claim that because paragraph 6 of Section 5 of the Transportation Act provides that, on consolidation, the capitalization "shall not exceed the value of the consolidated properties," the Commission should encourage the gradual adjustment of the capital of the carriers to the value of the properties. This is based on a mistaken interpretation of the words "shall not exceed," and should not be considered, Commissioner Eastman believes, as these words do not coincide with the words "shall equal." There is no reason to believe that the consolidation of railway properties will necessitate a capitalization of surplus reserves.

Commissioner Ford, in dissenting, believed that the essence of the proposition was whether the Commission should facilitate and conserve the present relations between the three roads and to help them to obtain financial accommodations on favorable terms. He desired to authorize bonds as well as stock.

Approval of owning lines' plan for the same refunding purpose.[2]— When the northern lines a month later developed and presented

[1] J. C. Bonbright, "High Finance on the Railroads," *Nation*, December 8, 1920, Vol. III, pp. 637–38.

[2] *Finance Docket 1374, I.C.C.* The Commission advises that the decision will be permanently reported in Vol. LXVII, *I.C.C.*, p. 458.

their own plan for the same purpose of refunding the maturing obligations, the Commission approved their bond issue,[1] even though it was made at much greater expense. The approval was largely on the ground that the Great Northern and Northern Pacific were rightly assuming the obligation rather than burdening the owned road, and hence that it was proper for their joint bonds to be used for the purpose.

The Commission examined the outstanding capitalization of the Northern Pacific and the Great Northern, the price they were to receive for these bonds, and approved the capitalization of extensions by the Northern Pacific. It also approved a new type of mortgage for the Great Northern, so that the two roads could share equally in the obligation.

Commissioner Eastman again dissented from the finding of the majority, in the belief that a less expensive plan would be approved by the old security holders, not from charity, but from their own "enlightened self-interest." They were, however, given no opportunity to investigate such an alternative.

THE LACKAWANNA STOCK DIVIDEND[2]

The second important decision on the matter of capitalizing surplus is that for the Delaware, Lackawanna, and Western Railroad, which shares with the Burlington the honor of being one of the two most profitable railroads in the United States.

This road made large profits from the mining end of its business, as well as from its operations as a carrier, and in the course of its long life a book surplus had been built up aggregating $90,500,000, in spite of the fact that large dividends had always been paid. The Lackawanna asked permission to capitalize this entire surplus, and then to issue it as a stock dividend. If the full amount had been authorized, it would have made a 200 per cent stock dividend on the outstanding stock. Even as authorized, the dividend was 100 per cent, for on April 18,

[1] *Finance Docket No. 1374, I.C.C.* Submitted April 11, 1921, decided April 21, 1921, amended May 6, 1921.

[2] *Finance Docket 65, I.C.C.* References are to sheets of the advance copies of the decision. The Commission advises that the decision will be permanently reported in Vol. LXVII, *I.C.C.*, p. 426.

1921, the Commission granted the right to capitalize $45,000,000 of the surplus, or about half the amount asked for.

The point of interest to us in this case is the *kind* of property which the Commission was willing to include in the capitalization.

The principal facts were as follows: The Lackawanna is a prosperous road, having its genesis in the Liggett's Gap Railroad Company, organized in 1832 to build and operate a railroad from what is now Scranton, Pennsylvania, northerly to the New York State line.

Coal began to move over its various divisions in 1851, and the road's later prosperity is coincident with the development of the anthracite industry in eastern Pennsylvania. A major part of its lines are leased in perpetuity, rather than owned outright.

Prior to 1900 the entire road, including its controlled mileage, was not properly equipped to handle freight other than coal, but since 1900 the company has reinvested large portions of its excess earnings in the modernization and extension of its lines. They have been developed to a high state of efficiency.

Outstanding capitalization and property values.—The par value of Lackawanna stock in the hands of the public at the time of this application amounted to $42,220,550, and of bonds only $102,600. Lines under lease to the Lackawanna have outstanding $44,811,710 of stock and $53,697,657 of bonds, upon which the Lackawanna pays yearly rentals of over $5,000,000. This gives the stocks of the leased roads practically the status of bonds. It means that the Lackawanna's obligations amount to 42,220,550 of stock and $98,611,967 of funded debt, or total securities of $140,832,517.

Length of line operated by the Lackawanna is 960 miles. The entire system, including second, third, fourth, and switch tracks has approximately 2,700 miles of tracks, of which about 30 per cent are owned, and about 70 per cent leased or controlled. Per mile of road the capitalization therefore amounts to nearly $150,000, a very high rate.

When the Commission attempted to compare the outstanding stock with the value of the property, it met the usual diffi-

culty of incomplete early records. The cash value of the proceeds of stock sales appears on the books as $41,870,962.50, but nothing indicates what proportion was paid for in cash, what by service, or how much by other property. But stock dividends of nearly $11,000,000 are known to be included.

After a detailed comparison of the book value of the property and the stock, a fair conclusion of the amount paid in sacrifice was held by the Commission to be not in excess of $30,980,950. On the stock large dividends have been paid—averaging 12.8 per cent for sixty-six years. In 1909, the road paid a 72 per cent cash dividend; in 1917, 22½ per cent; and 20 per cent in every other year from 1905 to 1919.

Income and surplus.—Since 1853, the road has enjoyed a total net income of nearly $315,000,000. Over $210,000,000 of this has been paid out as dividends, and $14,000,000 as interest, leaving this book surplus of approximately $90,500,000—an amount but 8 per cent less than its total funded debt. None of the surplus had been capitalized prior to the current application.

The book surplus is made up of: (1) investments in its own road, (2) of investments in mining and other non-operating properties, (3) of railroad stocks and bonds, (4) of stocks and bonds of other properties, and (5) in "advances to leased lines." It also includes current assets above current liabilities, and net accounts with the United States Railroad Administration, but these are of negligible importance.

It is the full amount of this surplus which the road hoped to capitalize and issue as a stock dividend. If the full amount had been authorized, it would have amounted to a 200 per cent stock dividend on the amount of the Lackawanna stock outstanding.

Statutory obstacle to increase of capitalization.—The constitution of the state of Pennsylvania, which was adopted after the formation of the road, requires that no carrier may engage in the mining of coal for sale, if it is to be allowed to benefit under any general or special law of the state.

On February 9, 1901, the state legislature approved an act which allows a corporation which has been created by a special act of that body (the Lackawanna was created by a special act)

to increase its capital stock, provided it has the consent of a majority of its stockholders. This allows such a corporation to gain relief from some of the previous limitations of its charter.

If the Lackawanna were to be allowed to issue the stock dividend applied for at this time, it would therefore be necessary for it to cease mining coal, for sale, and this it planned to do. The road planned to divest itself of the mines, probably to "persons who now hold its stock"[1] in order to come within the provisions of these laws. Counsel for the road stated the Lackawanna had not previously attempted to increase its stock because of these restrictions.

By selling the mines to a new corporation, taking its stock in payment, and distributing this stock to the Lackawanna stockholders as a dividend, the road believed it would receive the best possible price for the properties.

With this legal disability removed, the road claimed the right to capitalize the full amount of its surplus and to issue these securities as a stock dividend.

Arguments in support of the stock issue.—Among the reasons advanced in support of the proposed issue were the following: (1) That refusal to grant the authorization would discourage public investment in railroad securities, since some inducements must be offered investors in railroad stock to make up for the security and certainty of principal and interest which is offered by mortgage bonds; (2) that denial would cause stockholders to demand hereafter the distribution of surplus as dividends instead of allowing it to be used for betterments and extensions;[1] (3) that present returns were excessive on the outstanding capitalization of the road, and a greater issue of stock would tend to allay distrust and suspicion on the part of the public, because the present large rate of return would be reduced when spread over the larger capitalization; and (4) that the capital of the road should be increased so as to equal the value of the property. This last was urged under the provisions of Section 5 of the

[1] *Finance Docket No. 65, I.C.C.*, sheet 8.

[1] See note regarding Professor Bonbright's criticism in the *Nation*, December 8, 1920.

Transportation Act, which states that, on consolidation, the capital of a new company shall not exceed the value of the separate properties. This claim was of no real importance and was at once rejected.

Points at issue in the Lackawanna case.—As distinct from the determination of the mere existence of the surplus, which had of course to be done here as in the Burlington case which we have considered, the issues in the Lackawanna case concerned: (1) The *type* of property represented by the surplus which the road may capitalize, (2) whether or not a *right* to such issue rests with the road, and (3) whether or not an implied trust exists that funds acquired from earnings should be left in the business or used for the public benefit.

Decision in the Lackawanna case.[1]—The Commission found that authority to issue stock cannot be claimed as a right by a carrier. Authority to approve or deny such issues rests within the discretion of the Commission. "If applicant is lawfully entitled to earn a return upon the fair value of the property acquired out of surplus, this right will persist, whether or not the stock issue is permitted."[2]

It also held that there was no proof that this surplus was the result of excessive charges, even though a part of it was accumulated prior to regulation: holding that where surplus results from rates not regulated by the state, it is the property of the company, and no implied trust exists that funds so acquired be left in the business or used for the public benefit. Such an application of the doctrine of implied trust would only penalize those carriers who came nearest to benefiting the public by extending and improving their roads out of surplus in the early days of the industry—at a time when the public needed the extensions and had put in effect the policy of laissez faire in order to encourage such development. This reasoning was held, however, not to

[1] The following commissioners participated in the decision of the Lackawanna case of April 18, 1921 (*Finance Docket No. 65, I.C.C.*), Clark, *chairman*, McChord, Meyer, Hall, Daniels, Aitchison, Eastman, Potter, and Esch. Commissioner Eastman dissented from the views of the majority and filed a separate dissenting opinion.

[2] *Finance Docket No. 65, I.C.C.*, sheet 8.

warrant the authorization of issuance of securities merely upon a showing of invested earnings: Part of such earnings should be held for emergency needs.

In answering the contention that it would be detrimental to the interests of the stockholder to hold this surplus, the Commission did not share the applicant's apprehension. Such a reserve was held to be a direct benefit to the stockholder. It not only protects his dividends and the market value of his stock, but also his pro rata share of assets available in the event of dissolution.

In examining the make-up of the surplus, the Commission was willing to authorize the capitalization of only one-half the amount asked for. It laid down certain definite statements of policy in regard to the kinds of property which may be included in such capitalization, and these make up the vital part of the Lackawanna decision:

Restrictions as to types of property. 1. Stocks and bonds of other companies, when no direct corporate relations exist between these companies and the applicants, should not be capitalized, since they are not needed in the operation of the property. In the present case, the leases of lines covered by these securities are in perpetuity, and no stock ownership is required to maintain them.

2. Stocks and bonds of other industries and of the government are flexible. They should not be capitalized, as the securities themselves could be distributed, if desired. (One of the separate opinions[1] objects to this view on the ground that the securities mentioned could be used as collateral security for the new issue.)

3. The net account with the United States Railroad Administration should not be capitalized, since it is merely an unadjusted balance.

4. Likewise investments in non-operating properties, as they are of no known use in connection with the transportation industry.

[1] Commissioner Daniels, concurring, but on a different basis. *Finance Docket No. 65, I.C.C.*, sheet 16.

5. Nor should excess of current assets over current liabilities be capitalized, as they are necessary for the operation of the road; nor any amounts for mining materials and supplies since these would soon be sold.

6. But the surplus invested in railroad property owned by the applicant may be capitalized, as well as the items called "advances to leased lines." In the latter case, however, the Commission made the provision that such advances should be covered by evidences of indebtedness from the leased lines to the applicant.

This policy definitely limits the capitalization of surplus to the amount of the actual property investment of the carrier, or by greatest extension to its own property and that of closely related lines necessary to its existence as a carrier.

Extent of the dividend.—The amount of the surplus specifically allowed to be capitalized in this case was $45,000,000 and permission was also given to issue this as a stock dividend. This purpose was found to be for a lawful object, compatible with the public interest, and reasonably necessary and appropriate for such purpose. As issued, it amounted to a stock dividend of 100 per cent.

The remainder of the surplus above this sum was left in its existing form.

Comment from the dissenting opinion.—Commissioner Eastman, who is fundamentally opposed to the majority view favoring the capitalization of surplus on the ground that the public has a vested interest in such property, in dissenting from the majority opinion in the Lackawanna case, called attention to the "curious notion that property or wealth, shown only in the form of surplus accumulations, is 'concealed' and can only be brought to light by the declaration of stock dividends."[1] This was one of the arguments advanced by the road in support of its claim, and is indicative of the shallow basis on which the claims of the Lackawanna really rest, or at least of the dearth of material to advance in support of such claims.

[1] Commissioner Eastman's dissenting opinion, *Finance Docket No. 65, I.C.C.*, sheet 24.

FUNDAMENTAL DIFFERENCES

The fundamental differences in these several cases may be reduced to a very few. Outside of the routine matters of actual determination of the existence of a surplus, and of ascertaining the methods by which it came into existence (which would have to be examined in any event), the principal problem resolved:

1. Around the legitimacy of turning surplus accumulations into a form of capital which would pass out of the direct control of the railroad corporation and into the hands of owners.

2. The possibility that this new capital, after having been issued, would be used as a basis for future rate-making, loomed large and helped to make the situation difficult. One group of able men hold that it is unjust to ask the public to provide both the capital and the return. These men point out that the Supreme Court of the United States has not yet determined whether or not property acquired from surplus should be included in determining the "fair value" upon which rates are to be based, and believe, assuming a favorable decision in this matter, there is no precedent to guide rate-makers in providing returns on the two types of capitalization—one supplied by the stockholders and the other by the public. Should such returns correspond to each other or not?

The present desire of the railroads to capitalize this surplus is viewed as a desire for official recognition of the fact that the surplus is entitled to the same consideration in rate regulation that is accorded to capital investment. Will this impose upon the public a double charge for transportation? What limits could there be to such a rate structure?

3. The third matter in dispute is the legitimacy of issuing a type of security which will increase the fixed charges of the roads. The Burlington's bonds would have increased the road's fixed charges immediately by more than 65 per cent, and to this amount more would have been added when contemplated betterments were completed and the remainder of the bond issue was sold. Burlington officials claimed such excellent earnings for their road that its credit position would not be impaired by the

addition of the $4,800,000 annual fixed charges, but Professor Bonbright has called our attention to the absurdity of such claims.[1] The same arguments were offered in support of the Alton's recapitalization scheme a few years ago, he says, yet the Alton suffered one of the most miserable financial fiascos of recent years after putting the plan into effect. As soon as business depression arrived, the fixed charges on the bonds which it had exchanged for stock, and those with which it had capitalized surplus, proved too much for its impaired earning capacity.

Claims of excellent earnings are apt to be optimistic and to overlook the necessity of preparing for hard times and unforeseen emergencies. "Every penny of fixed charges weakens, by so much, the ability of a company to face such emergencies." The force of this argument is somewhat weakened by the actual position of the Burlington during the pending of the application we have been considering, for the plan was prepared and offered at the lowest point in the recent depression, when the road was serenely riding the worst business storm in years.

Bond issues of this type are generally felt to be justified only when necessary to secure additional capital, and never when assumed merely to pay dividends.

4. The fourth problem therefore is: What is a proper use of the proceeds of bond issues? Can an owned road assist its controlling owners in refinancing their controlling interest? Also, would a separation of the old community of interest between the Great Northern and Northern Pacific and the Burlington be detrimental to the future prosperity of the roads? All these are fundamental questions, but it is by no means certain that a refusal to authorize the Burlington to furnish the assistance to its owners that was requested in this application would change the existing relations between the roads, or, now that the Commission has refused, that it has made the slightest measure of difference.

Opinions favoring the bond issue sound.—If we grant that the stock dividends were justified, and I see no fundamental grounds for denying this, can we reasonably withhold approval of the bond issue? Its immediate effect would have been greater on

[1] J. C. Bonbright, *Nation*, December 8, 1920, Vol. III, pp. 637–38.

the roads concerned than that of the stock dividend. Refinancing was an immediate need that could not be delayed without serious harm. Now that the later and more expensive plan of the northern roads has been put into effect, the opinions of Commissioners Clark, Potter, Daniels, and Ford, who favored the Burlington bond issue, are seen to have been justified.

We reach our ultimate goal sometimes by a method of eliminating the outworn policies of the past. The progress of many sciences is marked by the things which have been left behind. In the case of the United States Supreme Court, soundly expressed minority opinions have so frequently become the basis for majority opinion in later cases that it is customary to weigh separate opinions as carefully as the effective decision itself, when examining all the possibilities of a situation.

I therefore believe it will be only a matter of time before the Interstate Commerce Commission adopts at least part of the minority views we have examined.

Is a corporation always distinct from its stockholders?—The Burlington bond issue was felt by the Commission to promise no public benefits which would outweigh the dangers involved, but the statement that the results would inure to the benefit of "parties other than the applicant" appears to me to be much too vague a pronouncement. The parties to be assisted in this case were the real owners of the road, as pointed out by Commissioner Potter in his opinion dissenting as to the denial of the bond issue.

The Commission has clouded the essential facts by speaking of the owners as "other parties." They have added an unnecessary and confusing concept to the legal distinction between the corporation and its stockholders. Can the child not help his father, even though grown to manhood and occupying a distinguished place in the community? Are the real relations of stockholders and corporation so divergent that one must ignore the other save only within the strict legal limits of their duties? If we must stretch our doctrine so far, we have indeed brought about the sort of impersonal relations in industry that must eventually take out of our corporations whatever of the human

element remains, and so lay our system bare to further attack on the general ground of being soulless.

Dividends and surplus accumulations.—As between the applications of the two roads before us, the Burlington had the better position in asking for permission to capitalize its surplus, since it had paid only small dividends during the period in which the surplus was set aside, while the Lackawanna had consistently paid a very large dividend rate during its entire history. This rate was both relatively and absolutely high, since the capitalization per mile of line is much greater in the case of the Lackawanna than in that of the Burlington. Undoubtedly some of the early rates charged by this road were excessive, and some of its surplus was accumulated under such high rates, but the view of the Commission is unquestionably sound, that the public had allowed unusually high rates in the early days in order to encourage the development of the roads.

Property rights in the surplus.—Of the three possible methods of interpreting the property rights which arise in connection with the surplus accumulations of the railroads, as mentioned at the beginning of this inquiry, the Commission has taken the stand that the first is the only legitimate one: i.e., that such earnings belong outright to the road because they were earned by efficient operation. Where they were earned under regulated rates, the Commission found no reason to believe such rates were excessive; and where the surplus arose before regulation was put into effect, as was the case with part of the Lackawanna's fund, it was conceded that the public would not have allowed such rates unless it were to receive a substantial gain from the service afforded.

The Commission rejected the doctrine that such surplus belonged either directly or indirectly to the public, or that any implied trust existed which would compel such indirect use of the fund.

The argument that such action will result in a vicious circle, first of capital increases and then of rate increases, in order to show earnings on the total capital, which will cause still more surplus earnings to emerge, which will again make it necessary to increase the capitalization, demanding yet further rate

increases in order that earnings may be shown, and so on, is based on a false premise. It overlooks entirely the fundamental maxim of the modern school of rate regulation: That before changes shall be made in the rate structure, adequate investigation shall be had of all the essential facts.

When our commissions hear the entire cause before making an adjustment, they must of necessity consider not merely the amount of the capitalization outstanding, but also its source. This they have been doing in all recent decisions, and so long as they continue to do so, the vicious circle will not come into existence. Therefore the public will not have to bear a double charge for railroad service.

More than that, the Interstate Commerce Commission is definitely committed to a plan of building on the best work of the past, rather than attempting to start a whole new scheme. Open-minded conservatism in reshaping the old policies to fit new conditions is the only ultimately sound basis of progress. Our difficulty with the use of the word "conservative" is that we have interpreted it as "hard-shelled obstructionist" or something of that sort, and in the effort to find a good word to express the idea, we have lost the vital spark of truth.

Effect on the public.—At least one important part of the decisions will not be possible to evaluation until a considerable time has elapsed: Just what effect has the granting of a stock dividend in a period of financial stress had on the public mind? Has public distrust and suspicion of railway securities been increased or diminished? This is a matter on which the officials of the roads had considerable doubt, as witness their claims in support of the Lackawanna application.

Only a few months before, the people had submitted to a horizontal increase in both freight and passenger rates on the plea that the old rates were inadequate to support the railroad service. Even granting the inadequacy of the rates for the railroad system as a whole, may we not reasonably conclude that the public is justified in objecting to granting such increases to all the roads, when as a matter of fact a few of them like the Lackawanna were so prosperous as to be truly opulent?

CONCLUSION

The Interstate Commerce Commission has been injected into the situation at an unusual time, but it has undertaken its responsibilities in a thorough way that should result in ultimate success, even though we may not believe that these early decisions have gone far enough.

The old opinion against the capitalization of any part of a company's surplus was undoubtedly warranted in view of past experiences. However, if our belief in the fundamental soundness of our present regulation is justified, the real cause of anxiety over the evils of surplus capitalization has been removed, because no such reserve will be impaired in a way that will imperil the financial structure of the carrier, so long as proper investigation is first made of the purpose of any proposed recapitalization.

Commissioner Eastman, who has already been quoted as antagonistic to the whole matter of capitalization of surplus, has sounded a constructive warning as we approach this difficult problem of security regulation, and I present it here as the best expression of the opposite view of the matter appearing in either of the decisions we have just considered. The Commissioner says:

> It is, I think, a matter of regret that the exercise of our new powers of supervision over the issue of railroad securities should be marked in a period of financial depression by approval of the declaration of stock dividends by carriers which have refrained from declaring such stock dividends in past years of prosperity when such supervision did not exist. Without increasing the volume of railroad property, it is proposed to increase the volume of railroad securities at a time when such securities are a drug on the market. Undercapitalized railroad corporations are a source of strength to the nation, and they are all too few.[1]

The entire financial world is interested in these decisions, for they will set a precedent of far-reaching consequence. To quote again from Professor Bonbright: "For what the Burlington and the Lackawanna are permitted to do can hardly be denied to other roads similarly situated."

H. F. Clark

University of Wisconsin

[1] *Finance Docket No. 65, I.C.C.*, sheet 24.